the Estate PLANNER

July/August 2006

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Premarital affairs

A prenup can tie up loose ends before you tie the knot

Prenuptial agreements (also known as premarital agreements) usually are associated with divorce, but they also can play an important role in estate planning. A prenup can help preserve your estate by protecting your assets against creditors and help ensure your property is distributed as you intend.

Election reform

Virtually every state has laws that make it difficult — if not impossible — to disinherit your spouse. Community property states give spouses a one-half interest in the couple's community property. Other states give surviving spouses a right of election that allows them to bypass your will and take an elective share of certain property.

The elective share may be a set portion of your estate — one-third, for example — or it may increase the longer you're married. Even in states without an elective share law, a surviving spouse may have the right to take "against the will."

Regardless of the approach your state uses, your spouse's right to disregard the terms of your will can wreak havoc on your plans. Perhaps you have children from a previous marriage and you want all or most of your property to go to them. Or maybe your biggest asset is a business and you want to be sure your children or other family members working in the business continue to control it after you're gone.

A properly written prenuptial agreement can be used to designate which of your assets constitute community or marital property and which remain your separate property. It can give your estate plan "teeth" by waiving community property or elective share rights, ensuring the terms of your will are obeyed. Also, by maintaining certain assets as separate property, you can shield them from your spouse's creditors.

Second thoughts? Consider a *post*nuptial agreement

What if you're already married? Is it too late to take advantage of a prenuptial agreement's estate planning benefits? Many states also recognize postnuptial agreements. They may be scrutinized more closely, however, for signs of fraud or undue influence.

Like all contracts, postnuptial agreements require adequate consideration. The marriage itself provides the consideration for a prenuptial agreement, but a postnuptial agreement requires something more. Some courts find that a mutual release of marital property rights is sufficient consideration, although this argument may not hold up if one spouse owns most of the couple's wealth. Other courts demand more, such as a transfer of rights to specific assets from one spouse to the other.

True confessions

To ensure a prenup endures even after the marriage ends, it's essential for each spouse to fully disclose his or her assets and to include a complete inventory of these assets in the agreement. By

detailing the property covered by the agreement and making sure any waiver of marital rights is clear, you can avoid future claims that your spouse didn't understand what he or she was giving up.

It's also a good idea for each spouse to have a separate attorney. Independent legal representation can help fend off any attempts to annul the agreement on grounds of undue influence, mistake or fraud.

Once you're married, it's important to keep your separate assets separate. Even an iron-clad prenup can be rendered ineffectual if you commingle your assets.

To have and to hold

One of the benefits of estate planning is the comfort that comes from knowing how your wealth will be distributed when you die. But if your plan calls for your spouse to receive less than he or she can claim under a right of election or community property laws, some of that certainty is lost. A prenuptial agreement can help ease your mind. ▮

Can you undo a CRT?

Terminating a charitable remainder trust isn't always possible

A charitable remainder trust (CRT) allows you to support your favorite charities while providing yourself with current tax benefits and a regular income stream. (See "ABCs of a CRT" on page 4.) But what if your circumstances change after you set up a CRT? Can you undo the trust? CRTs generally are irrevocable, but it may be possible to terminate one if applicable law permits it and all interested parties consent.

Reasons to terminate

Why would you want to terminate a CRT? Perhaps the trust's investments have underperformed, causing its value to decline and jeopardizing the charity's remainder interest. Perhaps you're short on cash and would like to receive your portion of the trust's value now rather than later. Or maybe you don't need the income and would prefer to see the charity enjoy your donation today instead of waiting until you die or until the trust term ends.

Whatever the reason, be sure to plan carefully. Terminating a CRT isn't always an option — it could be prohibited by state law or by the terms of your trust. And even if termination is allowed, there are specific steps you must take.

Any missteps and your CRT may be disqualified retroactively and you'll lose any previous tax benefits you claimed.

2 ways to terminate a CRT

One way to terminate a CRT is to assign your income interest in the trust to the charitable beneficiary — often referred to as an assignment termination. This may be a good option if you

no longer need the trust income. Before taking action, ensure such an assignment is permitted under state law and that the trust document doesn't expressly prohibit it.

After you assign your income interest, the charity no doubt will want immediate access to the trust principal. Depending on state law, this may happen automatically under the doctrine of merger, which provides for the termination of a trust when one party owns both the income and remainder interests. Otherwise, a court order may be required.

The second method of terminating a CRT — an actuarial split — is to divide the trust assets between yourself and the charity based on the actuarial present values of your respective interests. The IRS has issued several private letter rulings allowing actuarial splits of CRTs in cases where:

- State law permits termination of the trust,
- All of the parties consent to the termination, and
- The income beneficiaries are unaware of any medical conditions that would result in shorter life spans than those set forth in IRS life expectancy tables.

In some states, you'll need to petition a court for an order terminating the trust. You may also need to notify the state's attorney general or include him or her as a party to the court proceeding.

To support your actuarial present value calculations, it's a good idea to have a physician certify

ABCs of a CRT

You can contribute assets to a charitable remainder trust (CRT), and the trust pays you an income stream for life or for a term of years and then distributes what's left to a qualified charity. You receive a current income tax deduction equal to the present value of the charity's remainder interest. And you shield the contributed assets and all future earnings from estate and gift taxes.

There are two types of CRTs:

1. A charitable remainder annuity trust (CRAT) pays you an annual income of at least 5% of the initial value of the trust assets. After the trust is funded, additional contributions are prohibited. So, the payments you receive remain the same throughout the trust's term.
2. A charitable remainder unitrust (CRUT) pays you an annual income of at least 5% of the trust assets, valued annually. Additional contributions are permitted. So, the payments you receive will vary from year to year.

Which type to choose depends on your needs and circumstances. A CRAT offers the advantage of a fixed income stream, which protects you in the event the trust's value declines. A CRUT is riskier because income payments are tied to underlying asset values, but offers greater upside potential. All CRTs must be designed carefully to ensure they preserve a minimum level of benefits for the charitable beneficiary.

A CRT is an ideal tool for converting highly appreciated, low-yield investments into income-producing assets at a minimal tax cost. Suppose you own $200,000 worth of stock with a cost basis of $40,000. You could sell the stock and invest the proceeds in assets that pay, say, a 6% return. After paying $24,000 in capital gains taxes, you'll have $176,000 left to invest, producing a $10,560 annual income stream.

If you contribute the stock to a CRT, however, the trust can sell the stock tax-free and reinvest the full $200,000, resulting in a $12,000 annual payment. If the CRT is designed to make a 6% annuity or unitrust payment, you'll enjoy the income on the entire investment without having to pay capital gains taxes.

that you have no known medical conditions that would result in a shorter-than-normal life expectancy.

Tax issues

The IRS considers the termination of a CRT to be a sale or exchange between the income and charitable remainder beneficiaries, generally resulting in taxable capital gains to the income beneficiaries.

Suppose, for example, that you terminate a CRT and the present values of the income and remainder interests are $50,000 each. Also suppose that the trust assets have a basis of $40,000. Basis is allocated pro rata according to the respective interests of the income and remainder beneficiaries, in this case $20,000 each. If you terminate the trust through an actuarial split, IRS regulations provide that basis is disregarded in calculating your gain, so you'll be taxed on the entire $50,000.

If you assign your income interest to the charity, however, your gain will be reduced by your share of the basis, resulting in a $30,000 capital gain. You also can claim a $50,000 charitable deduction (subject, of course, to adjusted gross income limits).

IRS backs off CRT ruling — for now

Last year, the IRS issued a controversial ruling threatening charitable remainder trusts (CRTs) with disqualification unless the grantor's spouse waived his or her inheritance rights. The ruling was intended to address state laws that give your surviving spouse a right of election to receive a portion of your estate regardless of your estate plan's terms.

The new rules — found in Revenue Procedure 2005-24 — disqualified CRTs created on or after June 28, 2005, that are subject to a surviving spouse's right of election (regardless of whether the right is actually exercised).

After a barrage of complaints, the IRS has suspended the Revenue Procedure indefinitely. In Notice 2006-15, the IRS said that, until further guidance is issued, it will disregard a spousal right of election in evaluating a CRT. For now, a CRT will be disqualified only if a spouse actually exercises that right.

There had been some concern that terminating a CRT might be viewed as a prohibited act of self-dealing or as the termination of a private foundation, which could result in penalty taxes or even disqualification of the trust. Fortunately, the IRS has issued several private letter rulings confirming that early termination of a CRT isn't an act of self-dealing and isn't subject to termination taxes (so long as the assets are divided actuarially between the beneficiaries and the termination complies with state law).

Explore all angles before taking action

Under the right circumstances, terminating a CRT can be a win-win move for everyone concerned. Be sure to consult a professional to make sure that terminating the trust is permissible and done correctly, and that the benefits of termination outweigh the costs. ▮

Prepaid tuition strategy gets passing grade from IRS

For many people, the $2 million estate tax exemption (up this year from $1.5 million) and the $1 million lifetime gift tax exemption are more than enough to shield their assets from estate tax. But if the value of your estate exceeds the exemption amounts, you'll need some creative strategies to preserve your wealth for future generations.

In a recent private letter ruling (PLR) No. 200602002, the IRS gave its blessing to a planning technique that allows you to remove significant amounts of wealth from your estate tax-free, without using up your exemptions.

The ruling permits a taxpayer to prepay tuition for his six grandchildren through 12th grade, without triggering estate, gift or generation-skipping transfer (GST) taxes. Bear in mind that a PLR applies only to the taxpayer who requested it and sets no legal precedent. But it does provide valuable guidance on how the IRS may rule in similar cases.

The strategy approved in the PLR allows you to accelerate the process by paying tuition in advance.

The basics

An important estate planning goal is to find ways to share your wealth with your heirs without incurring transfer taxes or depleting your exemptions. One way to accomplish this is to take advantage of the annual gift tax exclusion, which allows you to transfer up to $12,000 per recipient tax-free (up this year from $11,000). If you elect to split gifts with your spouse, you can give up to $24,000 per recipient.

The problem with this approach is that it can take years to transfer a meaningful amount of wealth. You can give more, however, by paying tuition or medical expenses on behalf of your children or other heirs. As long as you make the payments directly to the school or health care provider, they're exempt from gift tax without consuming any of your exemptions or annual exclusions.

For example, each year, Tom and Mary give $24,000 to their granddaughter, Alice, to help pay for her $20,000 tuition and other education expenses. They would like to help out even more, but if they make additional gifts they'll have to pay gift taxes at rates as high as 46% or use their gift tax exemptions. But if Tom and Mary pay Alice's tuition directly to her school, they can still use their annual exclusion to give Alice up to $24,000, for a total tax-free gift of $44,000.

An accelerated program

The strategy approved in the PLR allows you to accelerate the process by paying tuition in advance. The taxpayer who requested the ruling planned to enter into separate written agreements with the school for each of his six grandchildren. Under the agreements, he would prepay the total annual tuition for each grandchild through 12th grade. The amounts would be based on the school's current tuition rates, and the grandfather or the children's parents would agree to pay any tuition increases in subsequent years.

The prepaid tuition would not guarantee enrollment or afford the grandchildren any additional

rights or privileges over other students. Also, the prepayments would be nonrefundable — that is, they would be forfeited to the school in the event a grandchild drops out or transfers to another school.

The IRS ruled that, under the facts presented, prepaid tuition was exempt from gift and GST taxes. The ruling has significant implications for people who want to remove large amounts of assets from their estates tax-free but don't have the time they need to accomplish this through annual exclusion gifts.

The PLR doesn't mention the ages of the six grandchildren or the school's tuition rates. But it's likely that the dollar amounts involved are substantial. Suppose the grandchildren are in grades 2, 3, 4, 5, 6 and 7 and that the average tuition is $15,000 per year. The grandfather could transfer $765,000 without paying gift, estate or GST taxes or using any of his exemption amounts. Plus, he would still be able to use the annual exclusion to make additional gifts to his grandchildren.

Study before choosing a strategy

The main disadvantage of the technique approved in the PLR is that you have to make nonrefundable payments to a specific school on behalf of a designated student. Unlike other educational savings vehicles, such as Section 529 college savings plans, you can't transfer the funds to another school or another person if the student transfers or drops out.

The most tax-efficient way to finance educational expenses is to start contributing early to a Section 529 plan, a Coverdell Education Savings Account, a tax-advantaged educational trust or some combination of these vehicles. These tools offer greater flexibility and less risk than the technique described in the PLR, but they also require more lead time because of contribution limits and the need to use your annual exclusion to avoid gift tax. But if you don't have the luxury of time, and you're looking for ways to shield large amounts of wealth from gift and estate taxes, the prepaid tuition strategy is worth further study.

Estate planning red flag

You fail to name a contingent beneficiary

It may surprise you to learn that it's impossible to die without an estate plan. If you don't create your own plan, the state has one for you: If you die without a will or living trust, the laws of intestacy determine who receives your property. This may produce a result you don't want.

Intestacy laws typically split your wealth between your spouse and children. If you have no spouse or children, your property is distributed to your parents, siblings or other family members according to established priority rules. But if you die leaving no known heirs, your property will be deemed abandoned and your legacy will become the property of the state.

It may surprise you even more that, even if you have a will or living trust, your property can still end up passing as though you were intestate. You may agonize over who will receive your property and craft a detailed estate plan to carry out your wishes, but it will all be for naught if you find yourself heirless.

To avoid this result, name a contingent beneficiary to receive your property in the event your heirs predecease you. The contingent beneficiary can be a charity or charitable foundation, a university, friends or anyone else you choose. Just remember, if you don't choose, the state will choose for you.

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